Market Commentary
Fourth Quarter 2015

"Sometimes your best investments are the ones you don't make"
(Donald Trump, US businessman, politician 1946 -)

Donald Trump has frequently made bold, outspoken and often controversial comments on all manner of issues, but there at least appears to be a kernel of wisdom in his quotation regarding investments. At the forefront of James Hambro & Partners investment philosophy is our recognition that it is at least as important to avoid the pitfalls of those investments that have the potential to permanently lose you capital, as it is to identify and back the winners. The past year has been one in which to avoid emerging markets and commodity-related investments, while stocks that enjoyed upgrades and outperformance in 2014 largely continued to do in 2015.

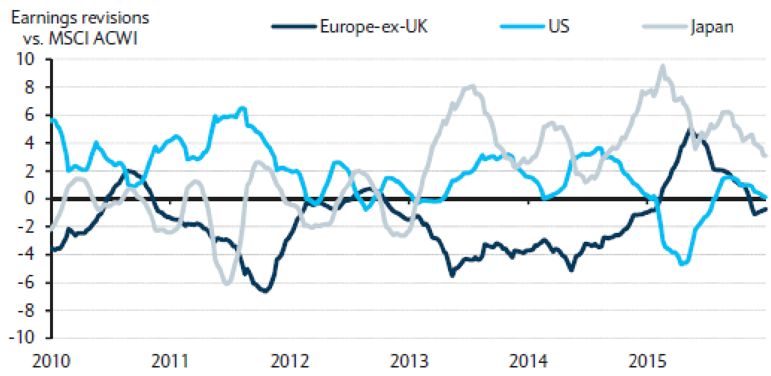
Last year saw lacklustre gains in many of the world's major asset classes; in local currency terms, the total returns for UK equities, gilts, corporate bonds, cash and US equities and treasuries were around 1% or lower. However, headline return figures were significantly influenced by currencies and also masked an underlying disparity of outcomes, not only between different geographic markets, but often within an individual market itself. On the face of it, a 4% total return for world equities in sterling seems a reasonable outcome, but this was only 1.8% in locally reported currencies and actually negative in dollar terms, while sterling returns for Japanese and Emerging Market equities were wildly divergent at +18% and -10%, respectively. There were also disparate results within individual markets, for example, the US energy sector declined by 23%, compared to a 10% gain for the leading Nasdaq 100 technology companies, while the UK All Share's second consecutive 1% annual gain is explained by a modest overall fall in the largest FTSE100 companies, offsetting most of the double-digit gain in the more domestically-focussed Mid-cap 250 stocks. For commodities, a slowing of Chinese demand, sluggish global growth and oversupply led to some steep price declines in oil and industrials metals; Brent oil has now fallen by two-thirds over the past 2 years, while copper and silver prices have both halved over the past 5 years.

If 2015 was largely a year for most investors to forget, what does the prospect of the current year bring? From an economic perspective, it would appear that conditions are gradually improving. The first US interest rate rise since June 2006 was generally welcomed amidst signs that the world's largest economy continues to strengthen, accompanied by measured comments from the Federal Reserve that it will only gradually feather the monetary brakes. In common with the agenda of central bankers in the UK, Japan and Europe, it appears that US expansionary policy conditions will prevail for as long as inflation remains subdued and further improvements in economic activity can take place. With the US and UK further along the road to recovery, we moved slightly underweight these two equity markets and followed the path of quantitative easing towards European and Japanese equities. Figure 1, below, additionally shows that the overall earnings revisions for Europe (dark blue line) and Japan (grey line), relative to the world, has been superior to the US (light blue line), albeit the latter has recently caught up with Europe. Although we recognise that earnings downgrades outnumber upgrades across the world, within sectors the declines are worst in the mining, energy and banking sectors and less prevalent in healthcare, utilities and insurance. Elsewhere, the Chinese slowdown from double-digit to mid single-digit growth is having a knock-on impact on its regional trading partners and commodity producing countries, hence our reduced exposure to Asia Pacific and zero allocation to Emerging

Markets. We are not tempted back into these areas yet, as there could be further uncertainty to come from China.

There have been no particularly strong conclusions on equity market valuations over the past few months; most remain around their historic average multiples, with Emerging Markets below average. Defensive sectors appear expensive compared to their long-run averages, with a higher premium being placed on stocks offering security of income and/or the prospect of dividend growth. The recent sharp fall in the high yield corporate bond market and US interest rate rise has perhaps nudged some previously circumspect investors into higher 'quality' equities. We continue to believe that, over the long term, we can obtain a better overall income and capital return from equities than bonds, through investing in a selection of excellent businesses, run by superior management teams. As an insurance against our central case and any heightened near-term volatility, we maintain prudent exposure to stabilising assets, such as index-linked bonds, absolute return funds, infrastructure and cash.

<u>Figure 1. Global earnings revisions</u>



Source: Barclays Research December 2015

7th January 2016